Michael C. Schlachter, CFA
Managing Director and Principal

November 1, 2010

Dr. Louis Moret
Chair, Investment Policy Subcommittee
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: Policy Revisions for Barclays Capital Aggregate Portfolio

Dear Dr. Moret:

You requested Wilshire's opinion with respect to the proposed revisions to the Statement of Investment Policy for the Barclays Aggregate Program (the "BA Policy").

Recommendation

Wilshire recommends that the Policy Subcommittee adopt the revised policies as presented. Staff is proposing to reduce the amount of tracking error or active risk in the Barclays Aggregate portfolio by tightening the duration and sector bands in the current policy.

Background

In the current BA Policy, Staff is allowed significant latitude across sectors and in managing the duration of the portfolio, relative to the Barclays Capital Aggregate Index. Staff is proposing tightening those bands to reduce tracking error, which should make the performance of the program more index-like. However, this tracking error reduction will in no way make the program an index fund or an enhanced index fund.

For example, under the current sector limitations, Staff could create a portfolio that used the extremes of the limitations, using 0% government bonds and maxing out or nearly maxing out the spread sectors of the portfolio. Using Wilshire's expected returns, volatilities and correlations across those asset classes, we would forecast a maximum tracking error of 2.46% (based solely on sector weights, ignoring duration and security selection). Under the proposed limits, we would forecast a maximum tracking error of 1.24%, a reduction of 50%.

We also note that under the proposed guidelines, Staff cannot max out all of the spread sectors simultaneously (the minimum government range becomes a binding constraint). Nor can Staff fully implement the maximum government weight (the sum of the minimum spread sector weights becomes a binding constraint). However, individually, any of the limits can be reached.

Similarly, the reduction in duration flexibility, from +/- 20% to +/- 10% of the benchmark duration will halve the risk to the portfolio that can come from a difference in yield curve management versus the benchmark.

While we support these changes, we reiterate our desire for asset class level tracking error limits to be incorporated into the respective policies across all appropriate asset classes. This is slated to be brought to the Investment Committee after the Asset Allocation Workshop. Given that the Investment Committee has not imposed tracking error limits on any of the investment programs to date, Staff and Wilshire do not know if these reductions in risk are sufficient or go too far for the long term management of this program. A comprehensive discussion of the expected tracking errors for all investment programs would provide much greater direction to Staff regarding the future management of many of the portfolios with the PERF, affiliates, etc.

Should you require anything further or have any questions, please do not hesitate to contact us.

Sincerely,